



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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Executive Director

January 4, 2012

Dear Interested Party:

Staff has reviewed comments received in response to our November 29, 2011, interested parties meeting regarding the proposed amendments to Regulation 1618, *United States Government Supply Contracts* and revisions to Audit Manual Chapter 4, *General Audit Procedures*. After considering the comments and information provided to date, staff is recommending more amendments to the regulation and changes to the audit manual.

Enclosed is the *Third Discussion Paper* on this subject. This document provides the background, a discussion of the issue and explains staff's recommendation in more detail. Also enclosed for your review is a copy of the proposed amendment to Regulation 1618 (Exhibit 1), proposed changes to Audit Manual Chapter 4 (Exhibit 2), copy of the submission from Mr. Joseph Vinatieri (Exhibit 3) and a summary of the differences between the two.

A third interested parties meeting is scheduled for **January 17, 2012 at 10 a.m. in Room 122** to discuss the proposed amendments to Regulation 1618 and Audit Manual Chapter 4. If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-4530 before the January 17, 2012 meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on January 17, 2012, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Ms. Judi Pierce at (916) 327-2045 or by e-mail at judith.pierce@boe.ca.gov prior to January 13, 2012. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing.

Any comments you may wish to submit subsequent to the January 17, 2012 meeting must be received by **January 31, 2012**. They should be submitted in writing to the above address. After considering all comments, staff will complete a formal issue paper on the proposed amendments to Regulation 1618 and Audit Manual Chapter 4 for discussion at the **Business Taxes Committee meeting** scheduled for **March 20, 2012**. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the March Business Taxes Committee meeting is welcomed. The meeting is scheduled for **10:00 a.m.** in Room 121 at 450 N Street, Sacramento, California.

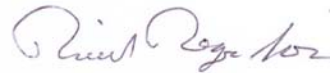
E-file now, find out how . . . www.boe.ca.gov



Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

We look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Kirsten Stark, Supervisor, Business Taxes Committee Team and Training Section at (916) 322-0849.

Sincerely,



Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

SB: jmp

Enclosures

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC 71)
Senator George Runner (Ret.), Member, Second District (MIC 78)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(Via E-mail)

Mr. Robert Thomas, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Lee Williams, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office

Ms. Kristine Cazadd

Mr. Jeffrey L. McGuire

Mr. Jeff Vest

Mr. Randy Ferris

Ms. Christine Bisauta

Mr. Bradley Heller

Mr. Robert Tucker

Mr. Cary Huxsoll

Mr. Todd Gilman

Ms. Laureen Simpson

Mr. Robert Ingenito Jr.

Mr. Bill Benson

Mr. Stephen Rudd

Mr. Kevin Hanks

Ms. Kirsten Stark

Ms. Leila Hellmuth

Ms. Judi Pierce

Ms. Lynda Cardwell

Ms. Nini McCormack

THIRD DISCUSSION PAPER

Proposed Revisions to Regulation 1618, *United States Government Supply Contracts* and Audit Manual Chapter 4, *General Audit Procedures*

I. Issue

Should Regulation 1618, *United States Government Supply Contracts*, be amended to conform the regulation to changes in the Federal Acquisition Regulation (FAR)?

Should Audit Manual Chapter 4, *General Audit Procedures*, be simplified and updated to reflect the changes to FAR?

II. Staff Recommendation

Staff recommends the following amendments to Regulation 1618 and to Audit Manual Chapter 4, *General Audit Procedures*. The proposed amendments reflect changes to the FAR. The amendments also incorporate suggestions submitted on December 13, 2011, by Mr. Joseph A. Vinatieri of Bewley, Lassleben & Miller, LLP, (Mr. Vinatieri), on behalf of Aerospace Industries Association (AIA).

Regulation 1618 – Staff’s proposed amendments are attached as Exhibit 1.

- Throughout the regulation - Number previously unnumbered paragraphs to provide points of reference and to comply with regulatory numbering protocol.
- Subdivision (a)(2) - Delete the last sentence to reflect that FAR no longer excludes “special tooling” from the definition of tools, and add an effective date for the inclusion of special tooling in direct consumable supplies.
- Subdivision (a)(3) - Add a statement that the allocation of overhead materials must be consistent with government cost accounting standards.
- Subdivision (b)(2)(A) and (B) - Separate the discussion of the application of tax to supplies into direct consumable supplies and indirect consumable supplies.
- Subdivision (b)(2)(B) - Delete the reference to title passage when indirect consumable supplies are allocated to contracts, some of which are other than government cost reimbursement contracts or fixed price contracts in which title transfers prior to use.
- Subdivision (b)(3) - Add a sunset date for the application of FAR 52.245-17. Following the sunset date, special tooling is included in the definition of direct consumable supplies.

Audit Manual – Staff’s proposed revisions are attached as Exhibit 2.

Section 0411.05-0411.25

- Update the FAR references throughout the section.
- Revise and reorganize the sections to simplify and clarify content.
- Include a section on audit procedures for classified contracts.

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Exhibits 10A-10F

- Change and renumber exhibits to reflect current FAR sections.
- Add a decision table to determine the correct application of tax when title transfers under a fixed price government supply contract. The table will also note the types of cost reimbursement contracts and highlight the nature of the title transfer.

III. Other Alternative Considered

In addition to the changes incorporated in the proposed revisions to the regulation and the audit manual, Mr. Vinatieri proposes the following additional revisions to the audit manual:

- Adding an assumption that fixed price contracts over \$2.5 million contain a progress payments clause.
- Using the term “award date of the contract” rather than “date of the contract.”
- Moving the references to research and development costs and bid and proposal expenses from the audit manual text to the decision table in Exhibit 10E.
- Not including a reference to different title passage provisions in effect prior to an August 2010 revision of FAR.
- Not including a reference that the auditor should test postings of purchases for United States Government contracts.
- Including a description of types of contracts in Exhibit 10E.

The submission also includes what staff believes to be non-substantive changes in the wording and organization of various sections of the audit manual.

The amendments proposed by Mr. Vinatieri are attached as Exhibit 3.

IV. Background

Regulation 1618 provides guidelines for the application of tax to purchases and sales made by United States Government supply contractors. The regulation was last amended in 1995 to incorporate the decision in *Aerospace Corporation v. State Board of Equalization* (1990) 218 Cal.App.3d 1300, which provided that title to overhead materials passes to the government prior to use when the appropriate title clauses are in the contract. Procedures for auditing government supply contractors are included in Audit Manual sections 0411.00 through 0411.25 and Exhibits 10A through 10F. The audit manual sections discuss the application of tax to direct and indirect consumable supplies based on the type of contract (fixed price or cost reimbursement) and the specific title clauses included in the contract.

FAR is the United States Government regulation governing the “acquisition process,” which is the process through which the government purchases goods and services, including the passage of title to the United States Government when purchasing goods from government supply contractors. In 2007, several of the government property clauses were combined into one clause.

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Regulation 1618 and related audit manual sections should be updated to reflect the new consolidated clause and the deletion of the separate title clauses for “special tooling” and “special test equipment.”

To date, staff has issued two discussion papers and held two interested party meetings to discuss the issue. The second interested party meeting was held on November 29, 2011. A copy of the second discussion paper is available at <http://www.boe.ca.gov/meetings/pdf/1618SDP.pdf>. A copy of the first discussion paper is available upon request.

V. Discussion

There were three significant changes to the FAR, which affect the application of tax under the California Sales and Use Tax Law:

- Several government property clauses for records, fixed price contracts, cost reimbursement contracts, and “As is” property were combined into one clause, 52.245-1. The FAR clauses referenced in the audit manual need to be updated to reflect the current numbering systems.
- The clauses for “special tooling” and “special test equipment” were deleted. Title to these items now transfers at the same time that title passes for other equipment and tooling under the government property clause. Both the regulation and the audit manual need to be updated to delete the references to the separate clauses and the different tax treatment of these items.
- A title transfer clause was added to the performance-based payments provision (52.232-32). Contracts that rely on this clause to pass title to property prior to use will not pass title until the date of the first performance-based payment. The use of property prior to the date of the first payment will generally be subject to tax. After the first payment, title to the property described in FAR 52.232.32 passes to the government prior to any use. This change has been incorporated in the audit manual.

Regulation 1618

In addition to staff’s proposed amendments to Regulation 1618, Mr. Vinatieri proposed separating the section discussing the application of tax to the use of direct and indirect consumable supplies into two paragraphs. Mr. Vinatieri also proposed removing the word “specifically” from subdivision (b)(2)(B), first sentence of paragraph. Staff agrees with the proposed changes, and incorporated these changes in the recommended amendments to Regulation 1618, as illustrated in Exhibit 1 and discussed in the following section.

Revisions Based on Changes to FAR

In the 2007 FAR update, “special tooling” is no longer excluded from the definition of tools. Previously, “special tooling” had its own clause, 52.245-17, which provided an option for the government to take title to the tooling. The clause did not automatically pass title prior to use; a

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Proposed Revisions to Regulation 1618, *United States Government Supply Contracts* and Audit Manual Chapter 4, *General Audit Procedures*

custom clause was required to pass title. “Special tooling” is now included in the Government Property clause 52.245-1.

- Staff recommends incorporating the FAR change by deleting the reference that tools do not include “special tooling” and adding a reference with the effective date in subdivision (a)(2).
- Subdivision (b) also includes a paragraph on “special tooling.” Staff recommends adding a sunset date to this provision.

Revisions Recommended for Clarity

- Under subdivision (b), the regulation refers to the government cost accounting standards. Mr. Vinatieri proposes adding a statement in subdivision (a)(3) that overhead materials must be allocated to contracts consistent with government cost accounting standards. Staff agrees with the recommendation, which maintains consistency within the regulation.
- In subdivision (b), Mr. Vinatieri proposes and staff agrees to segregate in two separate paragraphs the application of tax to the use of direct consumable supplies and indirect consumable supplies. At one time, the regulation had provided for separate applications. Before the *Aerospace* decision, tax applied if the indirect consumable supplies were charged to expense accounts and allocated to contracts, some of which were not United States Government cost reimbursement contracts or fixed price contracts with a progress payments clause. After the decision, the regulation was updated to combine the application of tax to direct consumable supplies with the application of tax to indirect consumable supplies, which made the regulatory language confusing and difficult to read.
- In new subdivision (b)(2)(B), Mr. Vinatieri proposes rewording this paragraph to provide when and if title to indirect consumable supplies (overhead supplies) passes to the United States Government prior to use. Staff and Mr. Vinatieri agree to delete the following phrase in proposed subdivision (b)(2):

...some of which are engaged in other than United States government cost reimbursement contracts and/or fixed-price contracts with a progress payments clause...

Non-substantive Changes to the Regulation

Staff made various non-substantive grammatical changes and corrections throughout the regulation, in agreement with Mr. Vinatieri.

Audit Manual

Staff recommends rewriting Audit Manual sections 0411.00-0411.25, *United States Government Supply Contracts*, and Exhibits 10A-10F to simplify and update the manual provisions to reflect

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changes to FAR and audit procedures. The rewritten information is organized into the following categories:

- General
- Title Clauses
- Types of Contracts
- Types of Costs
- Auditing Procedures

Whether or not title to supplies used in the performance of a United States Government supply contract passes to the government prior to use is dependent on the title clauses in the contract, the type of contract, and the type of supply. For ease of clarification, a table has been prepared summarizing the differences between staff's proposed changes and those proposed by Mr. Vinatieri on behalf of AIA (see Exhibit 4).

Section 0411.05, GENERAL

Staff recommends revising the section to update and simplify the information regarding the history of FAR and to add a reference to the new decision table included as Exhibit 10E. Mr. Vinatieri appears to agree with staff's proposed revisions to the section, except when the section refers to the auditor's review of various contracts.

Mr. Vinatieri recommends including a statement that fixed price contracts of \$2.5 million or less be sampled by the auditor to determine whether the necessary clauses are included in the contract rather than each contract being reviewed. This would only be the case if the decision table in Exhibit 10E indicates that these types of contracts may or may not include the necessary clauses.

As noted in the discussion of Audit Manual section 0411.10, Mr. Vinatieri also suggests that there be a presumption that fixed price contracts greater than \$2.5 million include the necessary clauses and that title to all property passes to the government on the award date of the contract. He believes the presumption is reasonable since these contracts are eligible for the financing provisions of FAR 52.232-16, Progress Payments, and since they are eligible, it is reasonable to assume that the supply contractor will enter into a financing arrangement with the government whenever a contract exceeds \$2.5 million. As explained in FAR 52.232-16, title to consumable direct and indirect supplies passes to the government on the date of the contract or at other described times when the necessary progress payments clause is present in the contract, resulting in a passage of title to the described property prior to use.

Section 0411.10, TITLE CLAUSES

Staff recommends updating the FAR references to reflect the consolidation of the government property clause (FAR 52.245-1). A summary of the various title clauses has been added, including the government property clause, the progress payments clause, and the performance-based payments clause. The reference to classified contracts was moved to the newly titled section 0411.25, Verification Procedures.

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As noted on the previous page, Mr. Vinatieri proposes that this section explain that fixed price contracts greater than \$2.5 million are eligible for financing under the progress payments provisions of FAR 52.232-16 and, as such, title to consumable supplies should be presumed to pass to the government on the award date of the contract. He does not appear to recommend any verification on the part of the auditor to ensure that this is the case, through sampling or otherwise.

Although staff has agreed that it is not necessary for the auditor to expend time verifying the inclusion of the necessary title clauses in a government supply contract when the contract is a direct cost reimbursement type (cost reimbursement or time and material contracts), this is not the case with fixed price contracts. As provided in the FAR, absent a financing agreement such as that found in FAR 52.232-16 or other specific requirements in the contract for passage of title, under a fixed price contract the contractor retains title to all property except for items identified as a deliverable end item. This means that unless the contractor is reimbursed for the cost of the property by the government as a direct item of cost, another title provision is present in the contract, or a provision is in place for financing payments by the government, title to the property will not pass to the government, except when the property is a deliverable end item or a component part of a deliverable.

This being the case, staff questions whether the proposed presumption is appropriate. Although it may seem reasonable to assume every government supply contractor who is eligible for a financing arrangement with the government enters into such a contract, this does not always appear to be the case. Nor does it appear that the government enters into a financing arrangement with all eligible contractors.

Under FAR 32.104, Providing contract financing, the government-contracting officer is to “provide government financing only to the extent actually needed for prompt and efficient performance, considering the availability of private financing and the probable impact on working capital of the predelivery expenditures and production lead-times associated with the contract or group of contracts....” Among other requirements, the contracting officer is to “avoid any undue risk of monetary loss to the Government through financing....”

Considering the other provisions of FAR 32.104, it does not appear prudent to include a presumption in the audit manual that the auditor is to assume a fixed price contract greater than \$2.5 million will always contain the progress payments clause provided by FAR 52.232-16 and, as such, no further verification or contract review is necessary. Comments from an audit staff member indicated that the auditor has encountered contracts for greater than \$2.5 million that do not contain the progress payments clause under FAR 52.232-16.

In addition to the \$2.5 million threshold, Mr. Vinatieri also proposes that the “award” date of the contract should be used as the date when title passes under the provisions of FAR 52.232-16 instead of the actual “contract” date. Staff does not believe this is appropriate. Staff recommends that the actual language in the FAR be used when possible. In this case, staff believes the “contract” date should be used to determine passage of title, as provided by the FAR, and is more preferable than using a term that may result in an assumption that title to property passed before or after the actual time the contract went into effect. Accordingly, staff

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recommends that the use of “award” date not be incorporated as part of the section revision. However, staff is open to further discussion of the matter.

Section 0411.15, TYPES OF CONTRACTS

Previously the section discussed all aspects of fixed price contracts, including the types of expenses. Because staff has added a simplified decision table as proposed Exhibit 10E, staff recommends this section provide a general discussion of the types of contracts, including cost reimbursement and fixed price contracts. Staff also proposes the inclusion of a FAR reference to explain that all cost reimbursement contracts are required to contain the government property clause. Effectively, this means that since cost reimbursement contracts are required to contain the appropriate clause and inclusion of the clause occurs retroactively when omitted in error, it is presumed that all cost reimbursement contracts include the required clause necessary to pass title to property prior to use. Given the auditor can verify that the contract is a cost reimbursement contract (including a time and material contract), the auditor may accept that the contract contains the government property clause without reviewing the actual contract. This presumption is reflected in the proposed audit manual revisions (see Exhibit 2). However, this is not the case with fixed price contracts.

As noted previously, staff has not incorporated Mr. Vinatieri’s proposal for a presumption that fixed price contracts over \$2.5 million always contain the progress payments clause and therefore title passes prior to use. Again, staff does not believe this to be the case based on the language in FAR and information obtained from audit staff. Also, FAR states that a contract is eligible for financing when certain conditions are met not that all eligible contracts contain financing agreements. In addition, a contract may be eligible for one of the payment clauses, not necessarily the progress payment clause. Title may pass at different times depending on the clause in the contract.

Mr. Vinatieri also proposes that when cost reimbursable and time and material elements are included in a fixed price contract, title passes prior to use for both direct and indirect supplies in the same manner as cost reimbursement contracts. Staff is unable to find support for this proposal in the FAR and is unclear regarding the nature of these contracts. As such, the proposal was not included in staff’s proposed revision. Staff is, however, open to further discussion.

Section 0411.20, TYPES OF COSTS

Staff recommends the title of the section be changed and that it discuss the types of costs. Previously, the section discussed cost reimbursement contracts. The proposed section discusses direct consumables, indirect consumables, special tooling and test equipment, and leases. The language has been simplified and updated to reflect the changes to FAR regarding special tooling and special test equipment.

The majority of the language proposed by Mr. Vinatieri is incorporated within the section revision. However, rather than deleting current language discussing Independent Research and Development (IRAD) and Bid and Proposal (B & P), staff has added a discussion on the costs which Mr. Vinatieri had suggested be included in the proposed decision table. Staff believes that

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the discussion is a better fit under the discussion of types of costs. In addition, staff has included a discussion on title passage rules for special tooling and special test equipment prior to the August 2010 FAR revision.

Mr. Vinatieri also requested that staff verify that it is the policy of the Department of Defense not to designate government contractors as legal agents of the United States. The statement is in the current version of the audit manual. Staff has been unable to confirm this fact, and has not revised the section on leases. Because the contractor does not obtain title to the property under a lease, the contractor cannot transfer title to the United States Government.

Section 0411.25, AUDITING PROCEDURES

The section previously discussed leases. Staff recommends that the section be changed to discuss audit procedures, including the review of classified contracts. Staff's proposal differs from Mr. Vinatieri's proposal in that staff does not include a statement that the auditor should accept that a fixed price contract with time and materials elements contains the government property clause. Staff could not find a reference in the FAR to support the statement.

Exhibits 10A-10E

Staff recommends changing and renumbering exhibits to reflect current FAR sections, as agreed to by Mr. Vinatieri. Staff also recommends adding a decision table to assist in determining the taxability of the use of tangible personal property based on the type of contract, the title clause, and the type of expense. Mr. Vinatieri agrees to the use of staff's decision table with some changes.

Originally, Mr. Vinatieri proposed the use of a matrix noting the types of contracts and specifying whether title passes prior to use. During the second interested party meeting, participants agreed that a decision table would be simpler to follow. In his December 13, 2011 submission, Mr. Vinatieri proposed changes to staff's initial decision table rather than the matrix.

However, instead of incorporating Mr. Vinatieri's proposed language on the type of contracts in Exhibit 10E, Decision Table, staff has proposed language to be included under Audit Manual Section 0411.15, Types of Costs. Staff also proposes a reference to title passage clauses for special tooling and special test equipment prior to the August 2010 FAR change. Mr. Vinatieri appears to believe the reference is unnecessary. Staff is open to further discussion regarding both issues.

VI. Summary

Staff proposes amending Regulation 1618 to incorporate the FAR changes that consolidate several property clauses into one clause. In addition to the consolidation, the specific clauses for "special tooling" and "special test equipment" were deleted, and a title clause was added to the Performance-Based Payments clause. As these changes also need to be reflected in Audit Manual Chapter 4, staff is including proposed revisions to the manual in the interested party process. In addition, staff is proposing including in the audit manual a discussion of the auditing of proprietary or classified contracts.

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After the first interested parties meeting, Mr. Vinatieri proposed a matrix discussing the types of government supply contracts. Rather than incorporate the matrix, staff had proposed a simplified decision table for inclusion in the audit manual. The proposed table was discussed at the second interested party meeting and additional information has been incorporated because of the discussion, including a statement that costs may include independent research and development costs.

A summary of the differences between staff's proposed revisions and Mr. Vinatieri's proposed revisions are attached as Exhibit 4. Staff is open to continued discussions regarding any areas of disagreement.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 12/30/2011

Regulation 1618. United States Government Supply Contracts.

Reference: Sections 6007 and 6381, Revenue and Taxation Code.

Aerospace Corp. v. St. Bd. of Equalization (1990) 218 Cal.App.3d 1300.

(a) Definitions.

(1) "United States Government supply contract" means a contract with the United States to furnish, or to fabricate and furnish, tangible personal property including ships, aircraft, ordnance, or equipment, whereby title to tangible personal property purchased for use in fulfilling the contract passes to the United States pursuant to the title provisions contained in the contract before the contractor uses the property to perform the function or act for which the property was designed or manufactured. The term "U.S. Government supply contract" does not include contracts to construct improvements on or to real property or to the purchase of tangible personal property for use in fulfilling such contracts.

(2) "Direct consumable supplies" means supplies, tools, or equipment consumed in the performance of a contract which are specifically identified to the contract and the actual cost of which is charged as a direct item of cost to the specific contract. ~~"Tools" as used in this definition does not include "special tooling" subject to the provisions of Federal Acquisition Regulation (FAR) 52.245-17 or any regulation(s) which succeeds FAR 52.245-17.~~ Effective June 14, 2007, "Tools" as used in this definition includes "special tooling" that was previously covered by Federal Acquisition Regulation (FAR) 52.245-17.

(3) "Overhead materials" means supplies consumed in the performance of a contract the cost of which is charged to an overhead expense account and then allocated to various contracts based on generally accepted accounting principles and consistent with government cost accounting standards.

(b) Application of Tax.

(1) Sales to U.S. Government supply contractors of tools, equipment, direct consumable supplies and overhead materials are sales for resale if the United States takes title pursuant to a United States government supply contract prior to any use of the property by the contractor to perform the function or act for which the property was designed or manufactured. Accordingly, tax does not apply to such sales even though the property does not become a component part of the tangible personal property furnished, fabricated, or manufactured by the contractor. If the contractor makes any use of the property to perform the function or act for which the property was designed or manufactured prior to the passage of title to the United States, tax applies to the sales to or to the use by the contractor.

(2) Whether title to direct consumable supplies and-or indirect consumable supplies (i.e., overhead materials) passes to the United States under a United States government supply contract and the time at which title passes will be determined in accordance with the title provisions contained in the contract, if any. ~~In a case where the cost of~~

(A) For direct consumable supplies, which are charged direct to the United States government contract, title passes to the United States government pursuant to the title passage clause(s) associated with that specific contract.

~~(A)(B)~~ F-or indirect consumable supplies (i.e., overhead materials) which are charged to an expense account which is then allocated to various locations, cost centers or contracts, some of which are engaged in other than United States government cost reimbursement contracts and/or fixed-price contracts with a progress payments clause, it will be considered that title did not pass to the United States government prior to use of the property, and tax will not apply with respect to the purchase or use of the property charged to the expense account, unless if the item is specifically accounted for as being charged allocated to a specific United States government supply contract, pursuant to the terms of which title passes to the United States prior to the use of the item. Property will be considered charged allocated to a specific United States government supply contract when it is allocated pursuant to:

~~(1)~~ 1. A accounting standards promulgated by the Cost Accounting Standards Board (Office of Federal Procurement Policy, Office of Management and Budget), if applicable; otherwise,

~~(2)~~ 2. G generally accepted accounting principles that are equitable, consistently-applied, and appropriate to the particular circumstances.

Direct consumable supplies identified in subdivision (b)(2)(A) and indirect consumable supplies (i.e., overhead materials) which may be allocated in ~~this-the~~ manner identified in subdivision (b)(2)(B) include, but are not limited to, property used to repair items of capital equipment when a portion of the contractor's use is properly allocable to its government supply contracts, notwithstanding the fact that title to the property being repaired remains with the contractor.

~~(2)(3)~~ Special Tooling. Effective December 29, 1989 through June 13, 2007, title will generally not pass prior to use by the contractor for special tooling which is subject to the Special Tooling Clauses of Federal Acquisition Regulation (48 CFR) 52.245-17. Title to such special tooling will pass prior to use by the contractor only if the agreement between the contractor and the United States government contains a custom clause providing for title passage prior to use by the contractor. Therefore, sales of special tooling will generally be subject to tax.

UNITED STATES GOVERNMENT SUPPLY CONTRACTS 0411.00

GENERAL 0411.05

The contract between the United States Government and the government supply contractor determines when title passes for property used in the performance of the contract. If title passes prior to use, the supply contractor may purchase the property for resale to the United States Government and the subsequent sale to the United States Government is exempt under section 6381 of the Revenue and Taxation Code. Exhibit 10E provides a decision table which may be used to assist the auditor in deciding if title to the property passes prior to use.

The United States Government established the Federal Acquisition Regulation (FAR) to set uniform policies and procedures for the acquisition of goods and services. Individual agencies may issue supplements to FAR that may supersede the current FAR if there is a conflict. Because of potential revisions to FAR and the agency supplements, contracts should be reviewed to determine what clauses are included. (See section 411.25 for classified contracts exception.) Several of the standard definitions and clauses are included as Exhibit 10A at the end of the chapter. The FAR is accessible at <https://www.acquisition.gov/far/>.

Tangible personal property sold to or used by contractors in the performance of a contract with the United States Government to improve real property is not addressed in this section. The provisions of Regulation 1521 continue to govern the application of tax to such sales or use of tangible personal property.

TITLE CLAUSES 0411.10

Generally, title will transfer to the government under one of the following three FAR title clauses:

FAR 52.245-1, Government Property (Exhibit 10D)

The clause has different title passage provisions for fixed price contracts and cost reimbursement or time and material contracts or cost reimbursement line items under fixed price contracts. In cost reimbursement or time and material contracts, or cost reimbursement line items in fixed price contracts, title passes prior to use for reimbursable items. However, in fixed price contracts, the clause will not pass title to items to the government unless the item is a deliverable or the contract contains a provision directing the contractor to purchase the item as a direct item of cost. For example, the government property clause will not pass title to items charged to an overhead expense account that is then allocated to specific contracts, as these items are not specifically identified in the contract. Also note that there is an alternate title clause for basic or applied research at nonprofit institutions of higher education or at nonprofit organizations whose primary purpose is the conduct of scientific research.

FAR 52.232-16, Progress Payments (Exhibit 10B)

Title passes at the date of the contract for property purchased prior to that date. Otherwise, title passes at the time the property is allocable or should have been allocable to the contract.

FAR 52.232-32, Performance-Based Payments (Exhibit 10C)

Title passes at the time of the first performance-based payment for property purchased prior to that date. Otherwise, title passes at the time property is allocable or should have been allocable to the contract. If title passes under this clause, there is the potential for use of the property prior to title passing to the United States Government for items purchased prior to the first payment. If there is a use prior to the first performance-based payment, the use by the contractor will generally be taxable.

In addition to the clauses described above, a contract could contain a title clause specific to that contract.

TYPES OF CONTRACTS 0411.15

The contract types are grouped into two broad categories: fixed-price contracts and cost-reimbursement contracts. The specific contract types range from firm-fixed-price, in which the contractor has full responsibility for the performance costs and resulting profit (or loss), to cost-plus-fixed-fee, in which the contractor has minimal responsibility for the performance costs and the negotiated fee (profit) is fixed. In between there are the various incentive contracts, such as flexibly-priced contracts, in which the contractor's responsibility for the performance costs and the profit or fee incentives offered are tailored to the uncertainties involved in contract performance.

Cost Reimbursement Contracts

FAR 45.107 states cost-type contracts, including time and material contracts, shall contain FAR 52.245-1, the government property clause. The only exception is for purchase orders for property repair. Therefore, the auditor may presume that a cost-type contract contains the government property clause unless it falls under the property repair exception.

Fixed Price Contracts

In fixed price contracts, the government property clause, FAR 52.245-1, passes title to contract deliverables and reimbursable direct items of cost provided for in the contract. In order to pass title to overhead supplies or consumables not directly provided for in the contract, the contract must contain either the progress payments clause or the performance-based payments clause described in section 0411.10. Fixed price contracts greater than \$2.5 million and contracts with qualifying small business concerns are eligible for contract financing and may contain either the progress payments clause or the performance-based payments clause. If the contract contains either clause, title would pass based on the provisions of the payment clause.

Flexibly Priced Contracts

A flexibly priced contract can be either a Fixed, Cost Reimbursement, or Time and Material contract. Passage of title is based on the type of contract and the FAR clauses noted in section 0411.10 that are included in the contract.

TYPES OF COSTS 0411.20

Direct Consumables

“Direct consumable supplies,” as defined by Regulation 1618, are those supplies which are consumed in the performance of a contract and are specifically identified to the contract and charged as a direct item of cost to the contract. In cost type contracts, title transfers prior to use for reimbursable costs. However, in fixed price contracts, title passage under the government property clause is dependent on whether the cost is reimbursable and whether the contract has a provision directing the contractor to purchase the property as a direct item of cost.

Indirect Consumables

Indirect consumable supplies (overhead materials) are supplies consumed in the performance of a contract, the cost of which is charged to an overhead expense account and then allocated to various contracts based on generally accepted accounting principles. Title to indirect consumables will pass prior to use in cost reimbursement contracts, time and material contracts and cost-reimbursable line items in fixed price contracts. Otherwise, in order for title to pass prior to use, the contract must contain a financing payments clause and title will pass as provided for under that clause. For title to pass at the time provided under a contract’s payment clause, the contractor must allocate the overhead materials among the various commercial and qualifying and non-qualifying government contracts by means of a reasonable system of allocation which conforms to governing federal regulations and generally accepted accounting principles. One acceptable method is an allocation based on direct labor hours.

“Overhead materials” includes amounts recorded in cost accumulation pools that are allocated to qualifying and non-qualifying contracts including United States Government and commercial contract(s). Contractors may have Independent Research and Development (IRAD) and Bid and Proposal (B & P) accounts that accumulate costs for these two tasks. These costs are not taxable only if a qualifying United States Government contract was in existence at the time of use and such costs were allocated to such contracts. For example, bid and proposal expenses will be subject to tax if they are incurred at a time when no qualifying government contract was in existence even though the contractor is awarded the contract and such costs are subsequently allocated to it. Some contractors may accumulate the IRAD and B & P costs in projects as if they were contracts. However, they are not contracts but costs.

Special Tooling and Special Test Equipment

Prior to August 2010, the Progress Payments clause and the Performance-Based Payments clause pass title only to that special tooling or special test equipment to which the government will acquire title under another clause in the contract. Therefore, if either of these clauses was present in a contract, purchases of special tooling or special test equipment will not be subject to tax only if the clause is used in combination with another clause that specifically passes title to the special tooling or special test equipment. Generally, the other clause will be the government property clause. In August 2010, the requirement that title pass under another clause was removed from the payment clauses.

Leases

In general, a lease of tangible personal property to a United States contractor is subject to tax whether or not such contractor is properly authorized to act as a purchasing agent of

the United States. However, leases are exempt when they are (1) to contractors that occupy the legal status of agents of the United States and (2) to non-agent cost-plus federal contractors, other than Department of Defense contractors, that act as agents when procuring from General Services Administration (“GSA”) Supply Sources (“FSS” or “ADPS”) pursuant to a letter of authorization issued by a federal contracting officer which has language creating an agency relationship.

It has been the policy of the Department of Defense not to designate government contractors as legal agents of the United States. Therefore, a lease between a Department of Defense contractor and a vendor would not include the United States as a party to such lease, notwithstanding any FAR provision which attempts to characterize the buyer-lessee as an agent for the Department of Defense. Consequently, lease payments made by a Department of Defense contractor, which are charged as direct consumable supplies to a fixed price contract or cost reimbursement contract are subject to the sales or use tax.

Should a Department of Defense contractor nevertheless claim agency relationship with respect to a lease, the contractor is required to provide documentation to support such claim. The documentation should be submitted to the Chief, Tax Policy Division with a copy to the Chief, Field Operations Division, for communication with the Secretary of Defense to ascertain the Department’s position with respect to the specific contract.

AUDITING PROCEDURES 0411.25

Classified or Proprietary Contracts

Based on federal regulations, the auditor may not view classified or proprietary contracts because they do not have sufficient security clearance. Generally, these types of contracts are cost reimbursement type contracts, including time and material contracts, and therefore are required to contain the government property clause. If the auditor can verify through other documentation that the contract is a cost reimbursement or time and material contract, the auditor may accept that the contract contains the government property clause without reviewing the actual contract.

The supply contractor is required to submit their costs to the government on a form listing the contract number, type of contract (cost, fixed or mixed), and a summary of the costs. The auditor may be able to identify the type of contract by this form which is subject to disclosure and available for the auditor’s review. This form may have different names, but relates to the Indirect Cost document that is provided by the Contractor to Defense Contract Audit Agency (DCAA) / Defense Contract Management Agency (DCMA) on an annual basis. The guidelines for the document and a sample are available at <http://www.dcaa.mil/chap6.pdf>.

If the contract is a fixed price contract, the auditor cannot assume that title passes prior to use. The auditor should verify that the contract contains a clause that passes title prior to use, as described in section 0411.10, before accepting that the sales qualify as exempt sales to the United States Government. However, the auditor may explore alternative audit methods that determine, with the least possible expenditure of time, the correct amount of tax due.

Regardless of the type of contract, staff must develop a comprehensive understanding of the internal accounting practices of the United States Government contractor under audit. For

example, staff could review the Government Contractor's Disclosure Statement, which is reviewed by DCAA on an annual basis to verify adherence to accounting practices identified in the Disclosure Statement to gain an understanding of the contractor's records. The auditor must be able to verify that the supplies and goods purchased for resale to the United States Government are in fact resold or that tax has been paid on the purchase price. On a test basis, purchases should be traced from the purchase to the sale. This would include tracing the posting of the cost to an overhead account, verifying the allocation method of the cost and the submission of the cost to the United States Government.

FEDERAL ACQUISITION REGULATIONS (FAR'S) CLAUSE DEFINITIONS EXHIBIT 10A

Page 1 of 2

FAR CLAUSE DEFINITIONS

2.101. Definitions

“Direct cost” means any cost that is identified specifically with a particular final cost objective. Direct costs are not limited to items that are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives.

“Indirect cost” means any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.

“Special test equipment” means either single or multipurpose integrated test units engineered, designed, fabricated, or modified to accomplish special purpose testing in performing a contract. It consists of items or assemblies of equipment including foundations and similar improvements necessary for installing special test equipment, and standard or general purpose items or components that are interconnected and interdependent so as to become a new functional entity for special testing purposes. Special test equipment does not include material, special tooling, real property, and equipment items used for general testing purposes or property that with relatively minor expense can be made suitable for general purpose use.

“Special tooling” means jigs, dies, fixtures, molds, patterns, taps, gauges, and all components of these items including foundations and similar improvements necessary for installing special tooling, and which are of such a specialized nature that without substantial modification or alteration their use is limited to the development or production of particular supplies or parts thereof or to the performance of particular services. Special tooling does not include material, special test equipment, real property, equipment, machine tools, or similar capital items.

45.101 Definitions

“Contractor-acquired property” means property acquired, fabricated, or otherwise provided by the contractor for performing a contract and to which the Government has title.

“Equipment” means a tangible item that is functionally complete for its intended purpose, durable, nonexpendable, and needed for the performance of a contract. Equipment is not intended for sale, and does not ordinarily lose its identity or become a component part of another article when put into use. Equipment does not include material, real property, special test equipment or special tooling.

“Government-furnished property” means property in the possession of, or directly acquired by, the Government and subsequently furnished to the contractor for performance of a contract. Government-furnished property includes, but is not limited to, spares and property furnished for repair, maintenance, overhaul, or modification. Government-furnished property also includes contractor-acquired property if the contractor-acquired property is a deliverable under a cost contract when accepted by the Government for continued use under the contract.

“Government property” means all property owned or leased by the Government. Government property includes both Government-furnished property and contractor-acquired property. Government property includes material, equipment, special tooling, special test equipment, and real property. Government property does not include intellectual property and software.

“Material” means property that may be consumed or expended during the performance of a contract, component parts of a higher assembly, or items that lose their individual identity through incorporation into an end-item. Material does not include equipment, special tooling, special test equipment or real property.

**FEDERAL ACQUISITION REGULATIONS (FAR'S) PROGRESS PAYMENTS EXHIBIT
10B**

CODE OF FEDERAL REGULATIONS

TITLE 48

FEDERAL ACQUISITION REGULATIONS SYSTEM

52.232-16

Progress Payments

52.232-16 Progress Payments.

As prescribed in [32.502-4\(a\)](#), insert the following clause:

Progress Payments (Aug 2010)

d) Title.

(1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.

(2) "Property," as used in this clause, includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices.

(i) Parts, materials, inventories, and work in process;

(ii) Special tooling and special test equipment to which the Government is to acquire title;

(iii) Nondurable (*i.e.*, noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment, and other similar manufacturing aids, title to which would not be obtained as special tooling under paragraph (d)(2)(ii) of this clause; and

(iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract.

(3) Although title to property is in the Government under this clause, other applicable clauses of this contract; *e.g.*, the termination clauses, shall determine the handling and disposition of the property.

(4) The Contractor may sell any scrap resulting from production under this contract without requesting the Contracting Officer's approval, but the proceeds shall be credited against the costs of performance.

(5) To acquire for its own use or dispose of property to which title is vested in the Government under this clause, the Contractor must obtain the Contracting Officer's

advance approval of the action and the terms. The Contractor shall (i) exclude the allocable costs of the property from the costs of contract performance, and (ii) repay to the Government any amount of unliquidated progress payments allocable to the property. Repayment may be by cash or credit memorandum.

(6) When the Contractor completes all of the obligations under this contract, including liquidation of all progress payments, title shall vest in the Contractor for all property (or the proceeds thereof) not—

(i) Delivered to, and accepted by, the Government under this contract; or

(ii) Incorporated in supplies delivered to, and accepted by, the Government under this contract and to which title is vested in the Government under this clause.

(7) The terms of this contract concerning liability for Government-furnished property shall not apply to property to which the Government acquired title solely under this clause.

FEDERAL ACQUISITION REGULATIONS (FAR'S) PERFORMANCE-BASED
PAYMENTS EXHIBIT 10C
CODE OF FEDERAL REGULATIONS
TITLE 48
FEDERAL ACQUISITION REGULATIONS SYSTEM

52.232-32
Performance-Based Payments

52.232-32 Performance-Based Payments.

As prescribed in [32.1005](#), insert the following clause:

Performance-Based Payments (Aug 2010)

(f) Title.

(1) Title to the property described in this paragraph (f) shall vest in the Government. Vestiture shall be immediately upon the date of the first performance-based payment under this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.

(2) "Property," as used in this clause, includes all of the following described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices:

(i) Parts, materials, inventories, and work in process;

(ii) Special tooling and special test equipment to which the Government is to acquire title;

(iii) Nondurable (*i.e.*, noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment and other similar manufacturing aids, title to which would not be obtained as special tooling under paragraph (f)(2)(ii) of this clause; and

(iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract.

(3) Although title to property is in the Government under this clause, other applicable clauses of this contract (*e.g.*, the termination clauses) shall determine the handling and disposition of the property.

(4) The Contractor may sell any scrap resulting from production under this contract, without requesting the Contracting Officer's approval, provided that any significant reduction in the value of the property to which the Government has title under this clause is reported in writing to the Contracting Officer.

(5) In order to acquire for its own use or dispose of property to which title is vested in the Government under this clause, the Contractor shall obtain the Contracting Officer's advance approval of the action and the terms. If approved, the basis for payment (the events or performance criteria) to which the property is related shall be deemed to be not in compliance with the terms of the contract and not payable (if the property is part of or needed for performance), and the Contractor shall refund the related performance-based payments in accordance with paragraph (d) of this clause.

(6) When the Contractor completes all of the obligations under this contract, including liquidation of all performance-based payments, title shall vest in the Contractor for all property (or the proceeds thereof) not—

(i) Delivered to, and accepted by, the Government under this contract; or

(ii) Incorporated in supplies delivered to, and accepted by, the Government under this contract and to which title is vested in the Government under this clause.

(7) The terms of this contract concerning liability for Government-furnished property shall not apply to property to which the Government acquired title solely under this clause.

FEDERAL ACQUISITION REGULATIONS (FAR'S) GOVERNMENT PROPERTY (FIXED PRICE CONTRACTS) EXHIBIT 10D

Page 1 of 2

CODE OF FEDERAL REGULATIONS

TITLE 48

FEDERAL ACQUISITION REGULATIONS SYSTEM

52.245-1 (a) and (e) and Alternate II

Government Property

52.245-1 Government Property.

As prescribed in [45.107](#)(a), insert the following clause:

Government Property (Aug 2010)

(a) *Definitions.* As used in this clause—

“Acquisition cost” means the cost to acquire a tangible capital asset including the purchase price of the asset and costs necessary to prepare the asset for use. Costs necessary to prepare the asset for use include the cost of placing the asset in location and bringing the asset to a condition necessary for normal or expected use.

“Cannibalize” means to remove parts from Government property for use or for installation on other Government property.

“Contractor-acquired property” means property acquired, fabricated, or otherwise provided by the Contractor for performing a contract, and to which the Government has title.

“Contractor inventory” means—

(1) Any property acquired by and in the possession of a Contractor or subcontractor under a contract for which title is vested in the Government and which exceeds the amounts needed to complete full performance under the entire contract;

(2) Any property that the Government is obligated or has the option to take over under any type of contract, *e.g.*, as a result either of any changes in the specifications or plans thereunder or of the termination of the contract (or subcontract thereunder), before completion of the work, for the convenience or at the option of the Government; and

(3) Government-furnished property that exceeds the amounts needed to complete full performance under the entire contract.

“Contractor’s managerial personnel” means the Contractor’s directors, officers, managers, superintendents, or equivalent representatives who have supervision or direction of—

(1) All or substantially all of the Contractor’s business;

(2) All or substantially all of the Contractor's operation at any one plant or separate location; or

(3) A separate and complete major industrial operation.

"Demilitarization" means rendering a product unusable for, and not restorable to, the purpose for which it was designed or is customarily used.

"Discrepancies incident to shipment" means any differences (*e.g.*, count or condition) between the items documented to have been shipped and items actually received.

"Equipment" means a tangible item that is functionally complete for its intended purpose, durable, nonexpendable, and needed for the performance of a contract. Equipment is not intended for sale, and does not ordinarily lose its identity or become a component part of another article when put into use. Equipment does not include material, real property, special test equipment or special tooling.

"Government-furnished property" means property in the possession of, or directly acquired by, the Government and subsequently furnished to the Contractor for performance of a contract. Government-furnished property includes, but is not limited to, spares and property furnished for repair, maintenance, overhaul, or modification. Government-furnished property also includes contractor-acquired property if the contractor-acquired property is a deliverable under a cost contract when accepted by the Government for continued use under the contract.

"Government property" means all property owned or leased by the Government. Government property includes both Government-furnished and Contractor-acquired property. Government property includes material, equipment, special tooling, special test equipment, and real property. Government property does not include intellectual property and software.

"Material" means property that may be consumed or expended during the performance of a contract, component parts of a higher assembly, or items that lose their individual identity through incorporation into an end item. Material does not include equipment, special tooling, special test equipment or real property.

"Nonseverable" means property that cannot be removed after construction or installation without substantial loss of value or damage to the installed property or to the premises where installed.

"Precious metals" means silver, gold, platinum, palladium, iridium, osmium, rhodium, and ruthenium.

"Property" means all tangible property, both real and personal.

"Property Administrator" means an authorized representative of the Contracting Officer appointed in accordance with agency procedures, responsible for administering the contract

requirements and obligations relating to Government property in the possession of a Contractor.

“Property records” means the records created and maintained by the contractor in support of its stewardship responsibilities for the management of Government property.

“Provide” means to furnish, as in Government-furnished property, or to acquire, as in contractor-acquired property.

“Real property” See Federal Management Regulation 102-71.20 (41 CFR 102-71.20).

“Sensitive property” means property potentially dangerous to the public safety or security if stolen, lost, or misplaced, or that shall be subject to exceptional physical security, protection, control, and accountability. Examples include weapons, ammunition, explosives, controlled substances, radioactive materials, hazardous materials or wastes, or precious metals.

“Surplus property” means excess personal property not required by any Federal agency as determined by the Administrator of the General Services Administration (GSA).

e) Title to Government property.

(1) The Government shall retain title to all Government-furnished property. Title to Government property shall not be affected by its incorporation into or attachment to any property not owned by the Government, nor shall Government property become a fixture or lose its identity as personal property by being attached to any real property.

(2) Fixed-price contracts.

(i) All Government-furnished property and all property acquired by the Contractor, title to which vests in the Government under this paragraph (collectively referred to as “Government property”), are subject to the provisions of this clause.

(ii) Title vests in the Government for all property acquired or fabricated by the Contractor in accordance with the financing provisions or other specific requirements for passage of title in the contract. Under fixed price type contracts, in the absence of financing provisions or other specific requirements for passage of title in the contract, the Contractor retains title to all property acquired by the Contractor for use on the contract, except for property identified as a deliverable end item. If a deliverable item is to be retained by the Contractor for use after inspection and acceptance by the Government, it shall be made accountable to the contract through a contract modification listing the item as Government-furnished property.

(iii) If this contract contains a provision directing the Contractor to purchase property for which the Government will reimburse the Contractor as a direct item of cost under this contract—

- (A) Title to property purchased from a vendor shall pass to and vest in the Government upon the vendor's delivery of such property; and
- (B) Title to all other property shall pass to and vest in the Government upon—
 - (1) Issuance of the property for use in contract performance;
 - (2) Commencement of processing of the property or its use in contract performance; or
 - (3) Reimbursement of the cost of the property by the Government, whichever occurs first.
- (3) *Title under Cost-Reimbursement or Time-and-Material Contracts or Cost-Reimbursable contract line items under Fixed-Price contracts.*
 - (i) Title to all property purchased by the Contractor for which the Contractor is entitled to be reimbursed as a direct item of cost under this contract shall pass to and vest in the Government upon the vendor's delivery of such property.
 - (ii) Title to all other property, the cost of which is reimbursable to the Contractor, shall pass to and vest in the Government upon—
 - (A) Issuance of the property for use in contract performance;
 - (B) Commencement of processing of the property for use in contract performance; or
 - (C) Reimbursement of the cost of the property by the Government, whichever occurs first.
 - (iii) All Government-furnished property and all property acquired by the Contractor, title to which vests in the Government under this paragraph (e)(3)(iii) (collectively referred to as "Government property"), are subject to the provisions of this clause.

Alternate II (*June 2007*). As prescribed in [45.107](#)(a)(3), substitute the following for paragraph (e)(3) of the basic clause:

(e)(3) Title to property (and other tangible personal property) purchased with funds available for research and having an acquisition cost of less than \$5,000 shall vest in the Contractor upon acquisition or as soon thereafter as feasible; provided that the Contractor obtained the Contracting Officer's approval before each acquisition. Title to property purchased with funds available for research and having an acquisition cost of \$5,000 or more shall vest as set forth in this contract. If title to property vests in the Contractor under this paragraph, the Contractor agrees that no costs shall be allowed for any depreciation, amortization, or use under any existing or future Government contract or

subcontract thereunder. The Contractor shall furnish the Contracting Officer a list of all property to which title is vested in the Contractor under this paragraph within 10 days following the end of the calendar quarter during which it was received. Vesting title under this paragraph is subject to civil rights legislation, [42 U.S.C. 2000d](#). Before title is vested and by signing this contract, the Contractor accepts and agrees that—

“No person in the United States or its outlying areas shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be otherwise subjected to discrimination under this contemplated financial assistance (title to property).”

DECISION TABLE EXHIBIT 10E

Fixed Price Contracts				
	FAR Clause Inserted in Contract			
	Government Property 52-245-1(e)(2)	Progress Payment 52.232-16(d)	Performance Base Payment ¹ 52.232-32(f)	Application of tax
Special Tooling and Special Test Equipment ²	N	--	--	2
	Y	--	--	Non-Taxable
Contract Deliverables and Cost Reimbursable Line Items in Contract ³	N	N	N	Taxable
	Y	--	--	Non-Taxable
	N	Y	N	Non-Taxable
	N	N	Y ¹	Non-Taxable ¹
Other Direct and Indirect Costs	N	N	N	Taxable
	Y	N	N	Taxable
	N	Y	N	Non-Taxable
	N	N	Y ¹	Non-Taxable ¹

¹ Title transfers after first performance payment. Milestone payments are a form of performance-based payments.

² Prior to August 2010, for title to transfer to special tooling and special test equipment under a progress or a performance base payments clause there must be another separate title clause to which the government is to acquire title.

³ For deliverables and direct costs which are direct items of cost in the contract, the government property clause is sufficient to transfer title prior to use.

Cost reimbursement and time and material contracts: Title passes prior to use for reimbursable direct and indirect (i.e. overhead materials) consumable supply costs.

Commercial Contracts: These contracts are non-qualified contracts in the contractor's rate calculation.

Independent Research and Development (IRAD) and Bid and Proposal (B&P): Although some contractors may treat as contracts, these are indirect consumable supply costs and are allocated to contracts similar to other reimbursable costs and not considered contracts.

From: [Diana Mateos](#)
To: [Pierce, Judith;](#)
cc: [Joe Vinatieri;](#)
Subject: Regulation 1618, Audit Manual Chapter 4, and Decision Table
Date: Tuesday, December 13, 2011 4:09:01 PM
Attachments: [CA BOE Exhibit 2 table REVISED for Joe with Boeing comments.docx](#)
[CA BOE Regulation 1618 SDP Ex 1 REVISED -final with Boeing Comments.docx](#)
[EXHIBIT 2.AuditManualChapter4.AIARevised12-13-11\(2\).docx](#)

Dear Ms. Pierce,

As a follow up to the November 29th Meeting of Interested Parties wherein you supplied BOE's proposed changes to Regulation 1618, Audit Manual Chapter 4, and the Decision Table, attached please find the changes on behalf of AIA to your documents. Please note that AIA's changes (additions/deletions) are shown highlighted in yellow, and comments are shown in purple writing. If you need any further assistance, please call me.

Thank you.

Diana Mateos
Secretary to Joseph A. Vinatieri, Esq.
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Second Discussion Paper
Staff's Recommended Amendments

Exhibit 1
Page 1 of 2

Regulation 1618. United States Government Supply Contracts.

Reference: Sections 6007 and 6381, Revenue and Taxation Code.

Aerospace Corp. v. St. Bd. of Equalization (1990) 218 Cal.App.3d 1300.

(a) Definitions.

(1) "United States Government supply contract" means a contract with the United States to furnish, or to fabricate and furnish, tangible personal property including ships, aircraft, ordnance, or equipment, whereby title to tangible personal property purchased for use in fulfilling the contract passes to the United States pursuant to the title provisions contained in the contract before the contractor uses the property to perform the function or act for which the property was designed or manufactured. The term "U.S. Government supply contract" does not include contracts to construct improvements on or to real property or to the purchase of tangible personal property for use in fulfilling such contracts.

(2) "Direct consumable supplies" means supplies, tools, or equipment consumed in the performance of a contract which are specifically identified to the contract and the actual cost of which is charged as a direct item of cost to the specific contract. ~~"Tools" as used in this definition does not include "special tooling" subject to the provisions of Federal Acquisition Regulation (FAR) 52.245-17 or any regulation(s) which succeeds FAR 52.245-17.~~ Effective June 14, 2007, "Tools" as used in this definition includes "special tooling" that was previously covered by Federal Acquisition Regulation (FAR) 52.245-17.

(3) "Overhead materials" means supplies consumed in the performance of a contract the cost of which is charged to an overhead expense account and then allocated to various contracts based on generally accepted accounting principles and consistent with government cost accounting standards.

(b) Application of Tax.

(1) Sales to U.S. Government supply contractors of tools, equipment, direct consumable supplies and overhead materials are sales for resale if the United States takes title pursuant to a United States government supply contract prior to any use of the property by the contractor to perform the function or act for which the property was designed or manufactured. Accordingly, tax does not apply to such sales even though the property does not become a component part of the tangible personal property furnished, fabricated, or manufactured by the contractor. If the contractor makes any use of the property to perform the function or act for which the property was designed or manufactured prior to the passage of title to the United States, tax applies to the sales to or to the use by the contractor.

(2) Whether title to direct consumable supplies and or indirect consumable supplies (i.e., overhead materials) passes to the United States under a United States government supply contract and the time at which title passes will be determined in accordance with the title provisions contained in the contract, if any. In a case where the cost of

Second Discussion Paper
Staff's Recommended Amendments

Exhibit 1
Page 2 of 2

(A) For direct consumable supplies, which are charged direct to the United States government contract, title passes to the United States government pursuant to the title passage clause(s) associated with that specific contract.

~~(A)(B)~~ F—or indirect consumable supplies (i.e., overhead materials) which are charged to an expense account which is then allocated to various locations, cost centers or contracts, ~~some of which are engaged in other than United States government cost reimbursement contracts and/or fixed price contracts with a progress payments clause,~~ it will be considered that title did not pass to the United States government prior to use of the property, and tax will not apply with respect to the purchase or use of the property charged to the expense account, unless if the item is specifically accounted for as being charged allocated to a specific United States government supply contract, pursuant to the terms of which title passes to the United States prior to the use of the item. Property will be considered charged allocated to a specific United States government supply contract when it is allocated pursuant to:

~~(1)~~— 1. Accounting standards promulgated by the Cost Accounting Standards Board (Office of Federal Procurement Policy, Office of Management and Budget), if applicable; otherwise,

~~(2)~~ 2. Generally accepted accounting principles that are equitable, consistently-applied, and appropriate to the particular circumstances. █

Direct consumable supplies identified in subdivision (b)(2)(A) and indirect consumable supplies (i.e., overhead materials) which may be allocated in ~~this the~~ manner identified in subdivision (b)(2)(B) include, but are not limited to, property used to repair items of capital equipment when a portion of the contractor's use is properly allocable to its government supply contracts, notwithstanding the fact that title to the property being repaired remains with the contractor.

~~(2)(3)~~ Special Tooling. Effective December 29, 1989 through June 13, 2007, title will generally not pass prior to use by the contractor for special tooling which is subject to the Special Tooling Clauses of Federal Acquisition Regulation (48 CFR) 52.245-17. Title to such special tooling will pass prior to use by the contractor only if the agreement between the contractor and the United States government contains a custom clause providing for title passage prior to use by the contractor. Therefore, sales of special tooling will generally be subject to tax.

UNITED STATES GOVERNMENT SUPPLY CONTRACTS 0411.00

GENERAL 0411.05

~~If title to tangible personal property used in performance of a~~ The contract between the United States Government supply contract passes to the U.S. Government prior to its use by the Government and the government supply contractor, then the sale to the determines when title passes for property used in the performance of the contract. If title passes prior to use, the supply contractor of that may purchase the property is a valid sale for resale, to the United States Government and the subsequent sale by to the contractor United States Government is exempt under section 6381 of the Revenue and Taxation Code. ~~The provisions of Regulation 1618 together with the title provisions in each individual supply contract determine the application of sales or use tax to consumable supplies and overhead materials purchased for use on the contract. The decisions in the cases cited in this section did not change the law, but did change the interpretation of existing law.~~

~~The purpose of this section is to discuss the guidelines to~~ Exhibit 10E provides a decision table which may be used in determining to assist the auditor in deciding if title passage and the resulting application of tax to to the property purchased by contractors for use in fulfilling the requirements of supply contracts with the U. S. Government. If there are no clauses in a contract which accelerate the passage of title to the U.S. Government, title to the property does not pass passes prior to use by the contractor. As an aid to understanding this discussion, applicable sections of the current Federal Acquisition Regulations (FAR) have been included as Exhibit 10 (A through F). The decisions in this section are based on these standard FAR clauses.

~~Prior to April 1, 1984 (the effective date of FAR), each federal agency had its own procurement regulations. Creation of the FAR in 1984 was an attempt to provide one set of procurement regulations which would apply to all governmental agencies. The Office of Federal Procurement Policy (OFPP), the office responsible for creating the FAR, regarded the FAR as a consolidation and simplification of existing agency regulations and not as a new set of regulations. Supplements issued by each agency were meant to deal with procurement situations peculiar to that agency and to provide necessary agency implementation procedures. Agency FAR supplements have, however, come to supersede the FAR when they conflict. For example, the FAR appears to permit contractors to purchase canned software for resale to the United States. The Department of Defense FAR Supplement (DFARS) does not.~~

~~FAR's are revised periodically and, therefore, in order to determine the tax application to a specific contract, the actual title clauses of that contract must be examined. Each contract must be examined for any modified clauses which may alter the application of tax. Additionally, agency supplements must be consulted to determine if any deviation from the FAR occurred regarding title passage.~~

The United States Government established the Federal Acquisition Regulation (FAR) to set uniform policies and procedures for the acquisition of goods and services. Individual agencies may issue supplements to FAR that may supersede the current FAR if there is a conflict. Because of potential revisions to FAR and the agency supplements, Fixed Price contracts less than \$2.5M, which may not contain the necessary title passage clause, (as identified on Decision Table Exhibit 10E), should be sampled each contract should be reviewed to determine what clauses are included. Several of the standard definitions and

clauses are included as Exhibit 10A at the end of the chapter. The FAR is accessible at www.acquisitions.gov.

Tangible personal property sold to or used by contractors in the performance of a contract with the United States Government to improve real property is not addressed in this section. The provisions of Regulation 1521 continue to govern the application of tax to such sales or use of tangible personal property.

TITLE CLAUSES 0411.10

~~The courts ruled in Lockheed Aircraft Corporation v. State Board of Equalization and Aerojet General Corporation v. State Board of Equalization (May 1978) and in Aerospace Corporation v. State Board of Equalization (March 1990) that, for purposes of the Sales and Use Tax Law, title to tangible personal property used in the performance of federal contracts passes to the government in accordance with the terms of the title clauses of each contract. Use of such property after title passes to the government is not subject to the use tax.~~

~~The title provisions incorporated into a contract with the United States Government determine the time of sale of the property to the United States and govern the taxability of purchases of the property by the contractor. Each contract must be examined for appropriate title clauses to determine if title to tangible personal property passes to the United States prior to use by the contractor.~~

~~If classified contracts are encountered, documentation must be supplied by the contractor to support the claim that certain title clauses are contained in questioned contracts. Acceptable documentation includes copies of those pages of the contract containing the appropriate title clauses which may be identified by number to the questioned contract. Normally, verbal statements will not be considered acceptable documentation.~~

~~The guidelines in this section apply when the Government enters into a contract *other than* for the purpose of conducting~~Generally, title will transfer to the government under one of the following three FAR title clauses:

FAR 52.245-1 Government Property (Exhibit 10D)

The clause has different title passage provisions for fixed price contracts and cost reimbursement contracts or cost reimbursement line items in fixed price contracts. In cost reimbursement contracts or cost reimbursement line items in fixed price contracts, title passes prior to use for reimbursable items. However, in fixed price contracts, the clause will not pass title to items unless they are specifically provided for in the contract. This clause will NOT pass title to overhead items, i.e. items charged to an overhead expense

identified in the contract. Also note that there is an alternate title clause for basic or applied research at nonprofit institutions of higher education or at nonprofit organizations whose primary purpose is the conduct of scientific research.

~~If such contracts are encountered, special considerations regarding passage of title must be considered as noted in the Alternate II for paragraph (c) of FAR 52.245-2 for fixed price contracts or in the Alternate I for paragraph (c) of FAR 52.245-5 for cost reimbursement contracts.~~

The title provisions

FAR 52.232-16 Progress Payments (Exhibit 10B)

~~Title passes at the award date of the contract are effective for California sales and use tax purposes notwithstanding the fact that they may be incorporated principally for the purpose of securing for property purchased prior to that date. Otherwise, title passes at the interest time the property is allocable or should have been allocable to the contract. NOTE: Fixed Price contracts greater than \$2.5M are eligible for progress payments, and would pass title upon the award date of the contract.~~

FAR 52.232-32 Performance-Based Payments (Exhibit 10C)

~~Title passes at the time of the first performance-based payment for property purchased prior to that date. Otherwise, title passes at the time property is allocable or should have been allocable to the contract. If title passes under this clause, there is the potential for use of the property prior to title passing to the United States Government for items purchased prior to the first payment. If there is a use prior to the first performance-based payment, the use by the contractor will generally be taxable.~~

FIXED PRICE

~~In addition, a contract could contain a title clause specific to that contract.~~

TYPES OF CONTRACTS 0411.15

General

~~The combination of the following clauses incorporated into fixed price contracts will determine when title passes to the United States and will govern the taxability of purchases by the contractor. In examining each contract, it is important to observe whether the following clauses are included in the contract:~~

~~“Progress Payments” clause, FAR 52.232-16 (Exhibit 10B) — Indirect (“overhead”) costs~~

~~“Government Property” clause, FAR 52.245-2 (Exhibit 10C) — Direct costs Amended in July 1985 to add an alternate paragraph (e) to be used in research contracts with certain nonprofit organizations. Amended effective December 29, 1989 to delete special tooling from title paragraph (e) and to provide specifically that special tooling accountable to the contract is not subject to the provisions of this clause.~~

~~“Special Tooling” The contract types are grouped into two broad categories: fixed-price contracts and cost-reimbursement contracts. The specific contract types range from firm-fixed-price, in which the contractor has full responsibility for the performance costs and resulting profit (or loss), to cost-plus-fixed-fee, in which the contractor has minimal responsibility for the performance costs and the negotiated fee (profit) is fixed. In between are the various incentive contracts, in which the contractor’s responsibility for the performance costs and the profit or fee incentives offered are tailored to the uncertainties involved in contract performance.~~

Cost Reimbursement Contracts

~~Cost type contracts are required to contain FAR 52.245-1, the government property clause. This clause passes title prior to use for cost reimbursable costs under the contract, including direct and indirect supplies. Time & Material contracts are a type of Cost Contracts, and are required to contain FAR 52.245-1, the government property clause. Therefore for Time & Material Contracts, title to direct and indirect supplies passes prior to use by the Contractor. In addition, Cost Reimbursable & Time & Material elements~~

included in a Fixed Price Contract would also pass title prior to use for both direct & indirect supplies.

Fixed Price Contracts

In fixed price contracts, Cost Reimbursable and Time & Material elements would pass title prior to use for both direct and indirect supplies, as identified in the previous section. For fixed price elements, there are 3 main FAR title passage clauses that can be used to pass title to the Government. (1) FAR 52.245-1: passes title to the Government if the contract contains a provision directing the Contractor to purchase property for which the Government will reimburse the contractor as a direct item of cost. (2) FAR 52.232-16 passes title to the Government at the award date of the contract, as identified in the title clause section 0411.10; and (3) FAR 52.232-32 passes title to the Government after receipt of the first performance base payment for property purchased prior to that date, or at time property is allocable or should have been allocable for property acquired after that date, as identified in the title clause section 0411.10. NOTE: Fixed price contracts greater than \$2.5M would be eligible for progress payments, and therefore would pass title upon contract award date. ~~the government property clause, FAR 52.245-17 (Exhibit 10E)~~

~~This is not a title clause and was amended in December 1989 to add paragraph (b) to clarify that the Government 1, only retains an option to take title to all special tooling covered by the contract.~~

Flexibly Priced Contracts

A flexibly priced contract can be a Fixed, Cost, or Time & Material contract. Passage of title is based on the contract type and the applicable FAR title passage clause as identified in either the Cost Reimbursement or Fixed Price contract sections identified above.

Special Tooling

~~The amendments to the title clauses affect the application of the tax to purchases by the contractor of special tooling other than tooling for which the contractor will be reimbursed as an item of direct cost under the contract. Each contract must be examined to determine which version of these clauses, if any, are included or if custom clauses are inserted which pass passes title to special tooling.~~

~~The Progress Payments clause passes title only to that special tooling to which the government will acquire title under another clause contract deliverables or direct items of cost provided for in the contract. Therefore, if a Progress Payments clause is present in a contract, purchases of special tooling will not be subject to tax only if this clause is used in combination with another clause which specifically passes title to the special tooling.~~

~~The following tax consequences will result from the various combinations of the FAR clauses for special tooling:~~

~~12-29-89 to present:~~

~~As of 12-29-89, the Government Property. The FAR 52.245-1 title passage clause does not pass title to indirect consumable supplies (i.e. overhead materials) which are charged to an overhead expense account, and allocated to a contract, as these costs are not identified as a direct item of cost under the contract. special tooling. If this is the only title clause present, tax will apply to purchases of special tooling by the contractor overhead supplies or consumables. In order to pass title to these indirect consumable supplies (i.e. overhead materials) supplies or consumables not directly provided for in the contract, the contract must contain one of the payment clauses described in section 411.10.~~

Special Test Equipment

~~If a contract contains the Government Property clause, title to special test equipment will pass to the government when the equipment's use in performing the contract begins or when payment is made to the vendor, whichever occurs first. For special test equipment, the Progress Payments clause passes title only to that special test equipment to which the government will acquire title under another clause in the contract.~~

~~Therefore, purchases of special test equipment will not be taxable only if a Government Property clause is present or a Progress Payments clause is present in combination with another clause which specifically passes title to special test equipment.~~

Consumable Supplies

~~Cost Reimbursement type contracts will generally are required to contain the government property clause and therefore title will pass prior to use for direct cost items and overhead items that are reimbursable. Generally fixed price contracts rely on one of the payment clauses to pass title for items that are not a deliverable or a direct cost item in the contract.~~

TYPES OF COSTS 411.20

Direct Consumables

~~"Direct consumable supplies" as defined by Regulation 1618 are those supplies which are consumed in the performance of a contract; and are directly specifically identified with a particular final cost objective. The term consists of those supply items the actual cost of which is to the contract and charged as a direct item of cost to the contract. Under a fixed price contract, title direct Direct consumable supplies does not pass to the United States when the Government Property clause is the only title clause present unless the contract contains an entitlement clause for such supplies as stipulated in FAR 52.245-2(c)(4). Consequently, if the Government Property clause is the only title clause may include items specifically provided for in the contract and items not specifically provided for in the contract the purchase or use of "direct consumable supplies" by the contractor will be subject to tax.~~

~~When the Progress Payments clause is present in a fixed price contract, title to "direct consumable supplies" vests in the United States as provided in FAR 52.232-16(d), i.e., upon the date of the contract for. In fixed price contracts, title passage under the government property which clause is dependent on whether the cost was purchased or produced before that date, and specifically provided for other property, upon the date it is or should have been allocable to in the contract.~~

Indirect Consumables

Indirect consumable supplies (overhead materials) are supplies consumed in the performance of a contract, the cost of which is charged to an overhead expense account and then allocated to various contracts based on generally accepted accounting principles.

The Government Property clause FAR 52.245-1 passes title to indirect consumable supplies prior to any use for Cost Reimbursable or Time & Material contracts. It also passes title to Cost Reimbursable or Time and Material elements in a fixed price contract This FAR does not pass title to indirect consumable supplies allocated to Fixed Price Contracts.. Title to indirect consumables will pass to Fixed Price contracts if the contract contains a FAR payment clause as identified in section 411.10. ~~If the Progress Payments clause is present in a fixed price contract, title to "overhead materials" which are allocable to the contract is passed to the United States upon acquisition, production, or allocation. However, in order to support the tax exempt status of the property, it becomes a matter of proof by the contractor that title passes to the United States prior to any use of the property by the contractor and that the property is used on an appropriate qualifying contract.~~

~~If the property is charged to overhead expense accounts which are later allocated to various cost centers or jobs, title to the property will be assumed to for fixed price contracts but does pass to the United States title prior to use of the property by the contractor if the contractor allocates for reimbursable costs under cost reimbursement contracts. For title to pass at the time identified in the applicable FAR title passage clauses, provided under a contract's payment clause, the contractor must allocate~~ the overhead materials among the various commercial and qualifying and non-qualifying government contracts by means of a reasonable system of allocation which conforms to governing federal regulations and generally accepted accounting principles. One acceptable method is an allocation based on direct labor hours.

~~In the Aerospace Corporation case, the court found that an allocation based on direct labor hours incurred on the contract was acceptable. There is no requirement that the contractor physically identify the specific materials through means of a requisitioning system. If the contractor has an acceptable system for allocating these costs, the overhead items should be treated as sold to the United States prior to any use by the contractor and the purchase or use of such items is not taxable.~~

"Overhead materials" includes account amounts recorded in cost accumulation pools which are allocable allocated to a based of qualifying and non-qualifying contracts including U.S. Government and commercial contract(s), ~~e.g., independent research and development, bidding and proposal and other service centers.~~ These allocations of pool costs are not taxable only if a qualifying U. S. Government contract was in existence at the time of use and such costs were allocated to such contracts. For example, bid and proposal reimbursable overhead materials expenses will be subject to tax if they are incurred at a time when no qualifying government contract was in existence even though the contractor is awarded the contract and such costs are subsequently allocated to it.

COST REIMBURSEMENT CONTRACTS 0411.20

~~The title provisions incorporated into cost reimbursement contracts will determine the time of sale to the United States and will govern the taxability of purchases by the contractor. There typically is only one title clause (Government Property clause FAR 52.245-5) incorporated into a cost reimbursement contract. (See Exhibit 10D.) This clause merely accelerates passage of title, and it is not mandatory that it be included in all cost reimbursement contracts. Each cost reimbursement contract must be examined to determine if an actual title clause is present. Generally, title to property purchased by the~~

~~contractor, the cost of which the contractor is to be reimbursed as a direct item of cost under the contract, will pass to or vest in the United States upon delivery of the property by the vendor. Title to other property, the cost of which is reimbursable to the contractor under the contract, will pass to or vest in the United States Government upon:~~

- ~~• issuance of the property for use in the performance of the contract,~~
 - ~~• commencement of processing or use of such property in the performance of the contract,~~
 - ~~or~~
 - ~~• reimbursement of the cost thereof by the United States Government,~~
- ~~whichever occurs first. However, proof that one of these three events occurs and that title passes to or vests in the United States prior to any use by the contractor must be provided by the contractor to support the tax exempt status of the property.~~

Special Tooling and Special Test Equipment

~~Special tooling and special test equipment are normally identified in a cost reimbursement contract as direct items of cost for which the contractor is to be reimbursed. Consequently, in accordance with the Government Property clause (FAR 52.245-5), title to such property vests in the United States upon delivery by the vendor to the contractor and all purchases of such property by the contractor are not taxable.~~

Consumable Supplies

~~As discussed in section 0411.15 under fixed price contracts, there are two classes of consumable supplies, "direct" and "indirect" (overhead materials). These terms are defined in the previous discussion of consumable supplies under fixed price contracts.~~

~~In accordance with Government Property clause 52.245-5, title to "direct consumable supplies" vests in the United States upon delivery by the vendor to the contractor and all purchases of such property by the contractor are not taxable.~~

~~Title to "overhead materials" normally passes to or vests in the United States upon the occurrence of one of the three events discussed above, i.e., issuance of the property for use in performing the contract, commencement of processing or use of the property in performing the contract, or reimbursement of the cost of the property by the United States. However, in order to support the tax exempt status of the property, it becomes a matter of proof by the contractor that one of these three events occurred prior to any use of the property by the contractor.~~

~~As discussed previously under fixed price contracts, title to the overhead materials allocated to qualifying government contracts, i.e., contracts with appropriate title clauses, will be assumed to pass to the United States prior to use by the contractor if the contractor allocates the materials among its various contracts by means of a reasonable system of allocation which conforms to governing federal regulations and generally accepted accounting principles.~~

LEASES 0411.25

Effective June 14, 2007, title to tooling identified under "direct consumable supplies" will pass to the Government under a Government property clause, such as 52.232-16; 52.232-32; or 52.245-1. Prior to this date, FAR Clause 52.245-17 must be present in order to pass title to the special tooling. The Progress Payments clause and the Performance-Based Payments clause pass title only to that special tooling or special test equipment to which the government will acquire title under another clause in the contract. Therefore, if either of these clauses is present in a contract, purchases of special tooling or special test equipment will not be subject to tax only if the clause is used in combination with another clause which

~~specifically passes title to the special tooling or special test equipment. Generally, the other clause will be the government property clause.~~

Leases

In general, a lease of tangible personal property to a United States contractor is subject to tax whether or not such contractor is properly authorized to act as a purchasing agent of the United States. However, leases are exempt when they are (1) to contractors that occupy the legal status of agents of the United States and (2) to non-agent cost-plus federal contractors, other than Department of Defense contractors, that act as agents when procuring from General Services Administration ("GSA") Supply Sources ("FSS" or "ADPS") pursuant to a letter of authorization issued by a federal contracting officer which has language creating an agency relationship.

It has been the policy of the Department of Defense not to designate government contractors as legal agents of the United States. Boeing comment: CA BOE will verify this statement with Helen Sutter from DCAA Therefore, a lease between a Department of Defense contractor and a vendor would not include the United States as a party to such lease, notwithstanding any FAR provision which attempts to characterize the buyer-lessee as an agent for the Department of Defense. Consequently, lease payments made by a Department of Defense contractor, which are charged as direct consumable supplies to a fixed price contract or cost reimbursement contract are subject to the sales or use tax.

Should a Department of Defense contractor nevertheless claim agency relationship with respect to a lease, the contractor ~~should be requested~~ is required to provide documentation to support such claim. The documentation should be submitted to the Chief, Tax Policy Division with a copy to the Chief, Field Operations Division, ~~Equalization Districts 1 and 2 and Out of State District or the Chief, Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section~~ for communication with the Secretary of Defense to ascertain the Department's position with respect to the specific contract.

AUDITING PROCEDURES 411.25

Classified or Proprietary Contracts

~~Based on federal regulations, the auditor may not view classified or proprietary contracts because they do not have sufficient security clearance. Generally, these types of contracts are cost reimbursement type contracts and therefore are required to contain the government property clause. If the auditor can verify through other documentation that the contract is a cost reimbursement contract, time and material contract, fixed price contract with time & material or cost reimbursable elements, or a fixed price contract with payment provisions, the auditor may accept that the contract contains the government property clause without reviewing the actual contract.~~

~~The contractor is required to submit their costs to the government on a form listing the contract number, type of contract (cost, fixed or mixed), and a summary of the costs. The auditor may be able to identify the type of contract by this form which is subject to disclosure and available for the auditor's review. This form may have different names, but relates to the Indirect Cost document that is provided by the Contractor to Defense Contract Audit Agency (DCAA)/Defense Contract Management Agency (DCMA) on an annual basis. Often this form is titled "Schedule H". BOEING COMMENT: CA BOE may revise to state, it contains the elements identified in Government link (to be provided by Susanne Buehler) Additional information is available from the United States Government at <http://www.dcaa.mil/chap6.pdf>.~~

If the contract is a fixed price contract, the auditor cannot assume that title passes prior to use. The auditor should verify that the contract contains a clause passing title prior to use, as described in section 411.10 before accepting that the sales qualify as sales for resale to the United States Government. Note that fixed contracts greater than \$2.5M are eligible for the progress payment clause, and therefore, should be considered qualified contracts (i.e. title passed prior to use). However, ~~t~~ The auditor may explore alternative audit methods that determine, with the least possible expenditure of time, the correct amount of tax due.

Regardless of the type of contract, staff must develop a comprehensive understanding of the internal accounting practices of the United States Government contractor under audit. For example, staff could review the Government Contractor's Disclosure Statement, which is reviewed by DCAA on an annual basis to verify adherence to accounting practices identified in the Disclosure Statement ~~flow charts of internal controls and corresponding practices to the extent possible~~ to gain an understanding of the contractor's records. The Disclosure Statement will identify the base over which each pool is allocated. Receipt of the Indirect Cost document that is provided to DCAA/DCMA on an annual basis, provides documentation that the overhead costs, accumulated in the pools identified on the Disclosure Statement, are allocated to the US Government contracts, and therefore resold to the extent of the qualifying contracts. The auditor should verify that tax has been paid on the allocation of the overhead material to the non-qualifying contracts. The auditor must be able to verify that the supplies and goods purchased for resale to the U.S. Government are in fact resold or that tax has been paid on the purchase price. ~~On a test basis, purchases should be traced from the purchase to the sale. This would include tracing the posting of the cost to an overhead account, verifying the allocation method of the cost and the submission of the cost to the U.S. Government.~~

DECISION TABLE EXHIBIT 10E

Fixed Price Contract Less Than \$2.5M				
	FAR Clause Inserted in Contract			
	Government Property 52-245-1(e)(2)	Progress Payment 52.232-16(d)	Performance Base Payment ¹ 52.232-32(f)	Application of tax
Special Tooling and Special Test Equipment ²	N	-- N	-- N	Taxable
	Y	--	--	Non-Taxable
	N	Y	N	Non-Taxable
	N	N	Y	Non-Taxable
Contract Deliverables and Direct Cost Items Provided for in Contract ³	N	N	N	Taxable
	Y	--	--	Non-Taxable
	N	Y	N	Non-Taxable
	N	N	Y ¹	Non-Taxable ¹
Other Direct and Indirect Costs	N	N	N	Taxable
	Y	N	N	Taxable
	N	Y	N	Non-Taxable
	N	N	Y ¹	Non-Taxable ¹

¹ Title transfers after first performance payment. **Milestone payments are a form of performance Base Payments.**

² ~~For title to transfer to special tooling and special test equipment under a progress or a performance base payments clause there must be another separate title clause to which the government is to acquire title~~ Effective June 14, 2007.

³ For deliverables and direct costs which are direct items of cost in the contract, the government property clause is sufficient to transfer title prior to use.

Cost reimbursement contracts: Title passes prior to use for **reimbursable costs, direct and indirect (i.e. overhead materials) consumable supply costs.**

Time & Material Contracts: Title passes prior to use for direct and indirect (i.e. overhead materials) consumable supply costs.

Cost reimbursable or Time & Material elements in Fixed Price Contracts: Title passes prior to use for direct and indirect (i.e. overhead materials) consumable supply costs.

Fixed Contracts > \$2.5M contracts: Contracts are eligible for progress payments. Title to direct and indirect (i.e. overhead materials) consumable supply costs pass on contract award date.

Commercial contracts: these contracts are classified as non-qualified contracts in the qualified (non-taxable) Contractor's rate calculation.

Flexibly Price Contracts: can be fixed; cost; or time and material contracts. Need to look at the guidance provided for each contract type to determine if the contract is qualified or not.

Independent Research & Development (IRAD) and Bid and Proposal (B&P) contracts are treated as indirect (i.e. overhead materials) consumable supply costs, and are allocated to contracts similar to other reimbursable costs. These costs are excluded from the calculation of the qualified (non-taxable) Contractor's rate.

Analysis of differences between changes proposed by AIA and changes proposed by staff

Section	Proposed by AIA	Proposed by Staff	Comments
0411.05 ¶1	Because of potential revisions to FAR and the agency supplements, Fixed Price contracts less than \$\$2.5M, which may not contain the necessary title passage clause, (as identified on Decision Table Exhibit 10E), should be sampled each contract should be reviewed to determine what clauses are included.	Because of potential revisions to FAR and the agency supplements, contracts should be reviewed to determine what clauses are included. (See section 0411.25 for classified contracts exception.)	AIA believes because fixed price contracts greater than \$\$2.5 million are eligible to contain a financing clause, the auditor should assume it does contain the clause. Staff does not agree that a contract will always contain a financing clause because it is eligible for the clause. In addition, for those contracts that do contain a clause, the auditor would need to verify whether it is a progress payments clause or a performance-based payments clause. This is not similar to assuming cost-type contracts include the government property clause. Federal regulation states that the contract shall contain the clause, not that the contract is eligible to contain the clause.
0411.10 ¶2	This clause will NOT pass title to overhead items, i.e. items charged to an overhead expense account that are allocated back to a specific contract, as these allocations are not specifically identified in the contract.	For example, the government property clause will not pass title to items charged to an overhead expense account that is then allocated to specific contracts, as these items are not specifically identified in the contract.	No substantive difference noted.
0411.10 ¶3	Title passes at the award date of the contract for property purchased prior to that date. Otherwise, title passes at the time the property is allocable or should have been allocable to the contract.	Title passes at the date of the contract for property purchased prior to that date. Otherwise, title passes at the time the property is allocable or should have been allocable to the contract.	1.The FAR clause uses the term date of the contract not the award date of the contract. Staff believes that the manual should use the same terminology as

Analysis of differences between changes proposed by AIA and changes proposed by staff

	NOTE: Fixed Price contracts greater than \$2.5M are eligible for progress payments, and would pass title upon the award date of the contract.		FAR. 2.As noted above, staff does not believe being eligible is the same as being required to contain a clause.
0411.15 ¶ 2	Time & Material contracts are a type of Cost Contracts, and are required to contain FAR 52.245-1, the government property clause. Therefore for Time & Material Contracts, title to direct and indirect supplies passes prior to use by the Contractor. In addition, Cost Reimbursable & Time & Material elements included in a Fixed Price Contract would also pass title prior to use for both direct & indirect supplies.	FAR 45.107 states cost-type contracts, including time and material contracts, shall contain FAR 52.245-1, the government property clause. The only exception is for purchase orders for property repair. Therefore, the auditor may presume that a cost-type contract contains the government property clause unless it falls under the property repair exception.	Since the second discussion paper, staff has added a reference to the FAR section requiring the government property clause. The reference to cost reimbursable elements in a fixed price contracts is discussed under the next section.
0411.15 ¶ 3	In fixed price contracts, Cost Reimbursable and Time & Material elements would pass title prior to use for both direct and indirect supplies, as identified in the previous section. For fixed price elements, there are 3 main FAR title passage clauses that can be used to pass title to the Government. (1) FAR 52.245-1: passes title to the Government if the contract contains a provision directing the Contractor to purchase property for which the Government will reimburse the contractor as a direct item of cost. (2)	In fixed price contracts, the government property clause, FAR 52.245-1, passes title to contract deliverables and reimbursable direct items of cost provided for in the contract. In order to pass title to overhead supplies or consumables not directly provided for in the contract, the contract must contain either the progress payment clause or the performance-based payment clause described in section 411.10. Fixed price contracts greater than \$2.5 million and contracts with qualifying small business concerns are eligible for contract financing and may contain either the progress payments clause or the performance-based payments clause. If the	Staff incorporated terminology from the FAR sections. In addition, there are the same differences pertaining to the \$2.5 million contracts and the use of the award date rather than the date of the contract which were discussed previously.

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	FAR 52.232-16 passes title to the Government at the award date of the contract, as identified in the title clause section 0411.10; and (3) FAR 52.232-32 passes title to the Government after receipt of the first performance base payment for property purchased prior to that date, or at time property is allocable or should have been allocable for property acquired after that date, as identified in the title clause section 0411.10. NOTE: Fixed price contracts greater than \$2.5M would be eligible for progress payments, and therefore would pass title upon contract award date.	contract contains either clause, title would pass based on the provisions of the payment clause.	
0411.15 ¶ 4	A flexibly priced contract can be a Fixed, Cost, or Time & Material contract. Passage of title is based on the contract type and the applicable FAR title passage clause as identified in either the Cost Reimbursement or Fixed Price contract sections identified above. The FAR 52.245-1 title passage clause does not pass title to indirect consumable supplies (i.e. overhead materials) which are charged to an overhead expense account, and allocated to a contract, as these costs are not identified as a direct item of cost under the contract. overhead supplies or consumables. In	A flexibly price contract can be either a Fixed, Cost Reimbursement, or Time and Material contract. Passage of title is based on the type of contract and the FAR clauses noted in section 0411.10 that are included in the contract.	Staff did not include information that was discussed elsewhere.

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	order to pass title to these indirect consumable supplies (i.e. overhead materials) the contract must contain one of the payment clauses described in section 411.10.		
0411.15 ¶ 5	Cost Reimbursement type contracts are required to contain the government property clause and therefore title will pass prior to use for direct cost items and overhead items that are reimbursable. Generally fixed price contracts rely on one of the payment clauses to pass title for items that are not a deliverable or a direct cost item in the contract.	NA	This information was incorporated in ¶ 3.
0411.20 ¶ 1	“Direct consumable supplies” as defined by Regulation 1618 are those supplies which are consumed in the performance of a contract; and are specifically identified to the contract and charged as a direct item of cost to the contract. In fixed price contracts, title passage under the government property clause is dependent on whether the cost was specifically provided for in the contract.	“Direct consumable supplies” as defined by Regulation 1618 are those supplies which are consumed in the performance of a contract and are specifically identified to the contract and charged as a direct item of cost to the contract. In cost type contracts, title transfers prior to use for reimbursable costs. However, in fixed price contracts, title passage under the government property clause is dependent on whether the cost was specifically provided for in the contract.	Staff has added sentence regarding cost type contracts.
0411.20 ¶ 2	The Government Property clause FAR 52.245-1 passes title to indirect consumable supplies prior to any use for Cost Reimbursable or Time & Material, contracts. It also passes title to Cost	Title to indirect consumables will pass prior to use in cost reimbursement contracts, time and material contracts and for cost-reimbursable line items in fixed price contracts. Otherwise, in	Staff believes there are only style differences to conform to manual style.

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	Reimbursable or Time and Material elements in a fixed price contract. This FAR does not pass title to indirect consumable supplies allocated to Fixed Price Contracts. Title to indirect consumables will pass to Fixed Price contracts if the contract contains a FAR payment clause as identified in section 411.10.	order for title to pass prior to use, the contract must contain a payment clause and title will pass as provided for under that clause.	
0411.20 ¶ 3	<p>“Overhead materials” includes amounts recorded in cost accumulation pools which are allocated to a based of qualifying and non-qualifying contracts including U.S. Government and commercial contract(s), e.g., independent research and development, bidding and proposal and other service centers. These allocations of pool costs are not taxable only if a qualifying U. S. Government contract was in existence at the time of use and such costs were allocated to such contracts. For example, bid and proposal reimbursable overhead materials expenses will be subject to tax if they are incurred at a time when no qualifying government contract was in existence even though the contractor is awarded the contract and such costs are subsequently allocated to it</p>	<p>“Overhead materials” includes amounts recorded in cost accumulation pools that are allocated to qualifying and non-qualifying contracts including U.S. Government and commercial contract(s). Contractors may have Independent Research and Development (IRAD) and Bid and Proposal (B & P) accounts that accumulate costs for these two tasks. These costs are not taxable only if a qualifying U. S. Government contract was in existence at the time of use and such costs were allocated to such contracts. For example, bid and proposal expenses will be subject to tax if they are incurred at a time when no qualifying government contract was in existence even though the contractor is awarded the contract and such costs are subsequently allocated to it. Some contractors may accumulate the IRAD and B & P costs in projects as if they were contracts. However, they are</p>	Staff reworted to include a discussion of the independent research and development cost and bid and proposal costs. Staff believes the rewording clarifies the topic.

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		not contracts but costs.	
0411.20 ¶ 4	Effective June 14, 2007, title to tooling identified under “direct consumable supplies” will pass to the Government under a Government property clause, such as 52.232-16; 52.232-32; or 52.245-1. Prior to this date, FAR Clause 52.245-17 must be present in order to pass title to the special tooling. The Progress Payments clause and the Performance Based Payments clause pass title only to that special tooling or special test equipment to which the government will acquire title under another clause in the contract. Therefore, if either of these clauses is present in a contract, purchases of special tooling or special test equipment will not be subject to tax only if the clause is used in combination with another clause which specifically passes title to the special tooling or special test equipment. Generally, the other clause will be the government property clause.	Prior to August 2010, The Progress Payments clause and the Performance-Based Payments clause pass title only to that special tooling or special test equipment to which the government will acquire title under another clause in the contract. Therefore, if either of these clauses was present in a contract, purchases of special tooling or special test equipment will not be subject to tax only if the clause is used in combination with another clause that specifically passes title to the special tooling or special test equipment. Generally, the other clause will be the government property clause. In August 2010, the requirement that title pass under another clause was removed from the payment clauses.	Staff added reference to title passage rules prior to August 2010.
0411.20 ¶ 5	It has been the policy of the Department of Defense not to designate government contractors as legal agents of the United States.	It has been the policy of the Department of Defense not to designate government contractors as legal agents of the United States.	DCAA did not respond to requests for information. Sentence left intact.
0411.25 ¶ 1	If the auditor can verify through other documentation that the contract is a cost reimbursement contract, time and	If the auditor can verify through other documentation that the contract is a cost reimbursement or time and material	Based on staff’s review of FAR.

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	material contract, fixed price contract with time & material or cost reimbursable elements, or a fixed price contract with payment provisions, the auditor may accept that the contract contains the government property clause without reviewing the actual contract.	contract, the auditor may accept that the contract contains the government property clause without reviewing the actual contract.	
0411.25 ¶ 2	Note that fixed contracts greater than \$2.5M are eligible for the progress payment clause, and therefore, should be considered qualified contracts (i.e. title passed prior to use).	NA	Staff does not agree that because a contract may contain a clause, it does contain the clause. This differs from FAR requiring that the contract contain a clause.
0411.25 ¶ 3	The Disclosure Statement will identify the base over which each pool is allocated. Receipt of the Indirect Cost document that is provided to DCAA/DCMA on an annual basis, provides documentation that the overhead costs, accumulated in the pools identified on the Disclosure Statement, are allocated to the US Government contracts, and therefore resold to the extent of the qualifying contracts. The auditor should verify that tax has been paid on the allocation of the overhead material to the non-qualifying contracts. The auditor must be able to verify that the supplies and goods purchased for resale to the U.S. Government are in fact resold or that tax has been paid on the purchase price. On a test basis,	The auditor must be able to verify that the supplies and goods purchased for resale to the U.S. Government are in fact resold or that tax has been paid on the purchase price. On a test basis, purchases should be traced from the purchase to the sale. This would include tracing the posting of the cost to an overhead account, verifying the allocation method of the cost and the submission of the cost to the U.S. Government.	Staff could not confirm information with DCAA. In addition, staff believes it is important that an auditor test postings to ensure that amounts are recorded correctly. This is a standard audit procedure.

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	purchases should be traced from the purchase to the sale. This would include tracing the posting of the cost to an overhead account, verifying the allocation method of the cost and the submission of the cost to the U.S. Government		
Exhibit 10E	Decision Table		<p>The substantive differences in the table are:</p> <ol style="list-style-type: none"> 1. Staff's table is for all fixed price contracts; AIA only addresses those less than \$2.5 million. AIA states those over \$2.5 will contain a payment clause and title will pass. 2. Staff's table addresses the change for special tooling and test equipment effective August 2010. 3. AIA includes additional descriptions on the types of contracts. Staff has included descriptions under Section 0411.15